DOW THEORY LETTERS INC.

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THE MARKET: I recently heard a commentator refer to this market as having "Silver in its hair, gold in its teeth and lead in its feet." Sounds rather accurate.

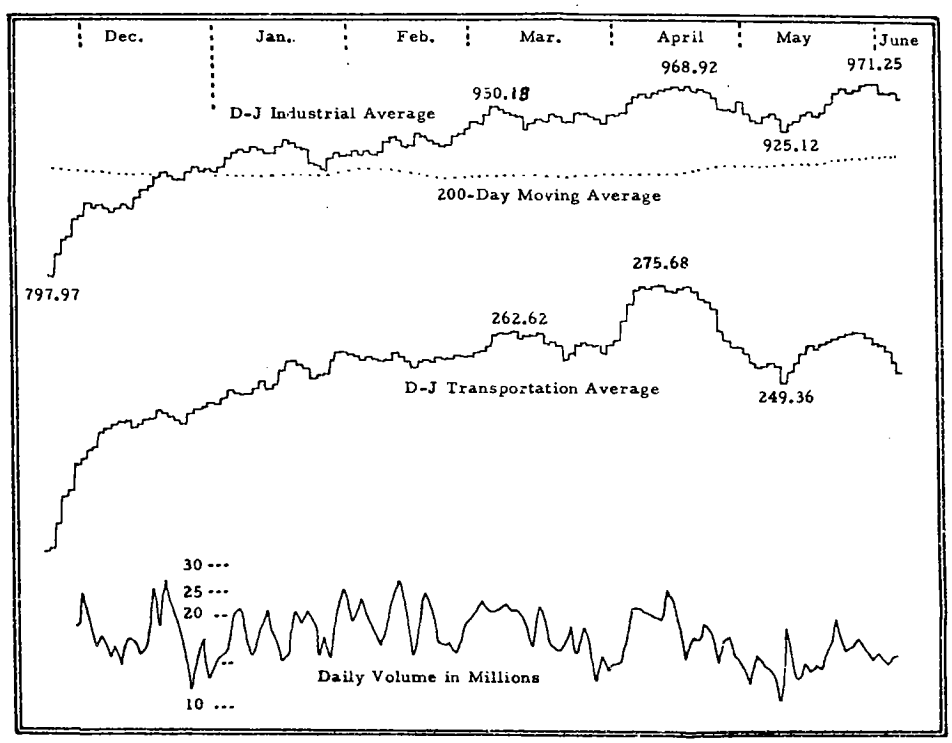
In the last Letter (530) I discussed a number of technical warnings, among them the fact that the Transports were failing to confirm the Industrials on the upside, the fact that Utilities were breaking to new lows for the year, and the fact that the advance-decline ratio was in a dangerous relationship with the Dow.

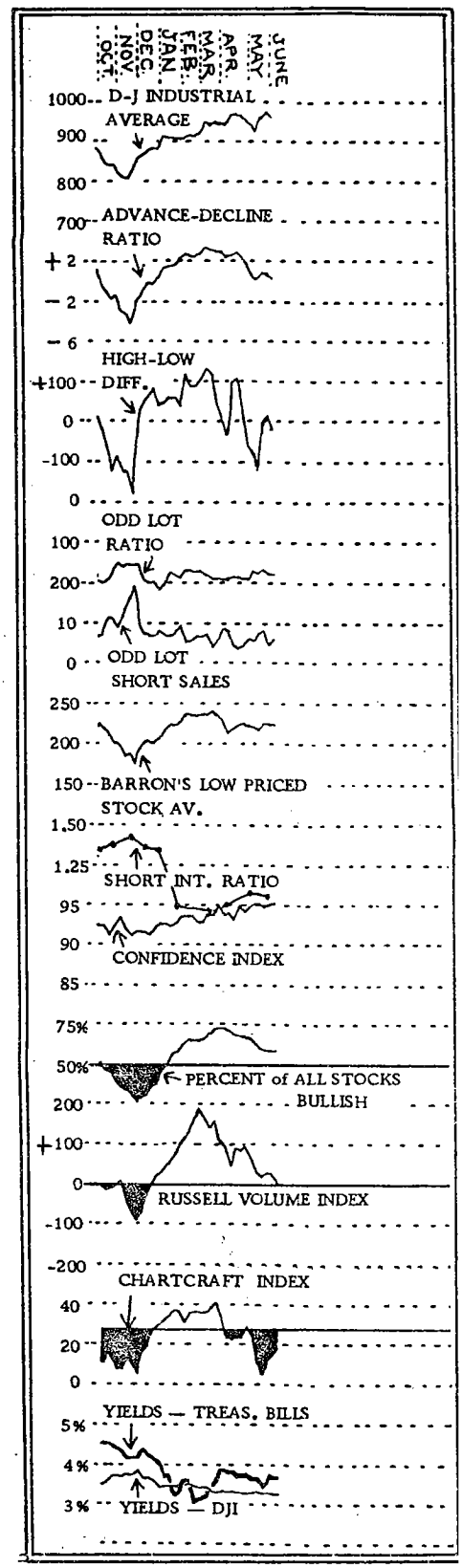
On May 26 the Industrial Average inched to a new recovery peak of 971.25, but Transports (see chart below) failed by a wide margin to confirm (they were actually selling off or diverging at the time). Two days before, the Utility Average had sunk to a low for the year. Thus the new May 26, high on the Dow (although widely cheered by Wall Street) could hardly be construed as bullish, at least by this observer.

More important, I have been drawing attention to the ominous relationship building up between the Industrial Average and the advance-decline ratio. I stated in Letter 530 that "...any new recovery high on the Dow (above 968.92) would be sure to produce a series of three descending peaks in the A-D ratio. In the past such 'triple divergences' have been the preamble for trouble ahead."

The action of May 26, in which the Industrials bettered its 968.92 peak, completed the picture as described above. The next day (May 30) saw the Dow rally, then close off 8¢. On May 31 the dangerous price-breadth relationship moved into full view as the Dow tumbled sharply amid a broad decline which hit almost every stock on the Board. As if to punctuate the deteriorating technical picture, General Motors sank to a new low for the year. June 2 and 3 again saw new 1972 lows for the Utility Average.

I feel the relationship between the Dow and the A-D ratio is absolutely crucial here, and I will go into it in detail in the next section of this Letter. This is not to diminish the





 other danger signals which are now flying, such as the poor performance of the Transports and the Utilities, but the story being told by the Dow and the A-D ratio is so extraordinary at this juncture that it deserves all the attention I can give it.

h week thousands of dollars worth of advisory services pass my desk, and dozens and dozens of market indicators are reviewed. ...ny of these are now flashing danger signals, but I have not reviewed them (1) because space prohibits, and (2) because many of the best of these indicators are already receiving "too much" attention from technicians.

For instance, the specialists' short sales were running very high recently, and this bearish (for the market) item received wide publicity. The percentage of bullish advisory services has also soared over the past few months, and here again this fact was reported everywhere (when too many services are bullish, the implications are bearish for the market). The mutual funds have been flooded with redemptions, with the net outflow running a quarter of a billion dollars last month. On top of this, the percentage of cash held by the funds dropped to 4.8%, a very low figure, and one which suggests much liquidation of stock by the funds over the foreseeable future. But even Newsweek magazine picked up on this last week.

One newer indicator which I like is the lesser-known "Puts/Calls Ratio" (developed by Martin Zweig), and here we have been getting a heavy plurality of calls (options to make money on an advance) vs. puts (options to make money on the decline). In fact, according to Zweig the most recent figures show a collapse in the ratio, indicating a great preponderance of opinion (and betting) for an advance. These figures should be interpreted in reverse, in that the low ratio figures suggest lower markets ahead.

But all in all, I have elected to put special emphasis on the current relationship between the Dow and the advance-decline ratio, as this basic relationship is seldom understood and therefore widely misinterpreted.

PRICE-BREADTH RELATIONSHIP: I have been writing about price (as measured by the D-J Industrial Average) and breadth (as measured by the advance-decline ratio) for many years. My first real and detailed understanding of this vital relationship came from reading the little weekly bulletins put out by James Hughes, who was then working at Auchincloss, Parker, and Redpath, a New York brokerage firm. Hughes' reports contained a wealth of information regarding price and breadth, as well they should, since Hughes not only was one of the discoverers of the A-D ratio, but also spent a lifetime studying its implications.

Amazing as it may seem, very few market analysts are students of the price-breadth relationship. Most analysts mention that the ...D ratio is going "up" or "down" or that it is "confirming" this or that, but I would say that I almost never read anything really ...owledgeable about price and breadth, anything in the James Hughes class.

I have written many reviews of the price-breadth situation, and I believe I have absorbed much or most of Hughes' teachings. Among the price-breadth reviews which I have published was the one which appeared in Letter 315, February 22, 1966 (this was written within a few points of the 1966 market top). The Letter 315 study is, in my opinion, both important and completely relevant to today's market action. For this reason, I am reprinting it below, along with a 1965-66 price-breadth chart. I suggest that subscribers study this piece very carefully.

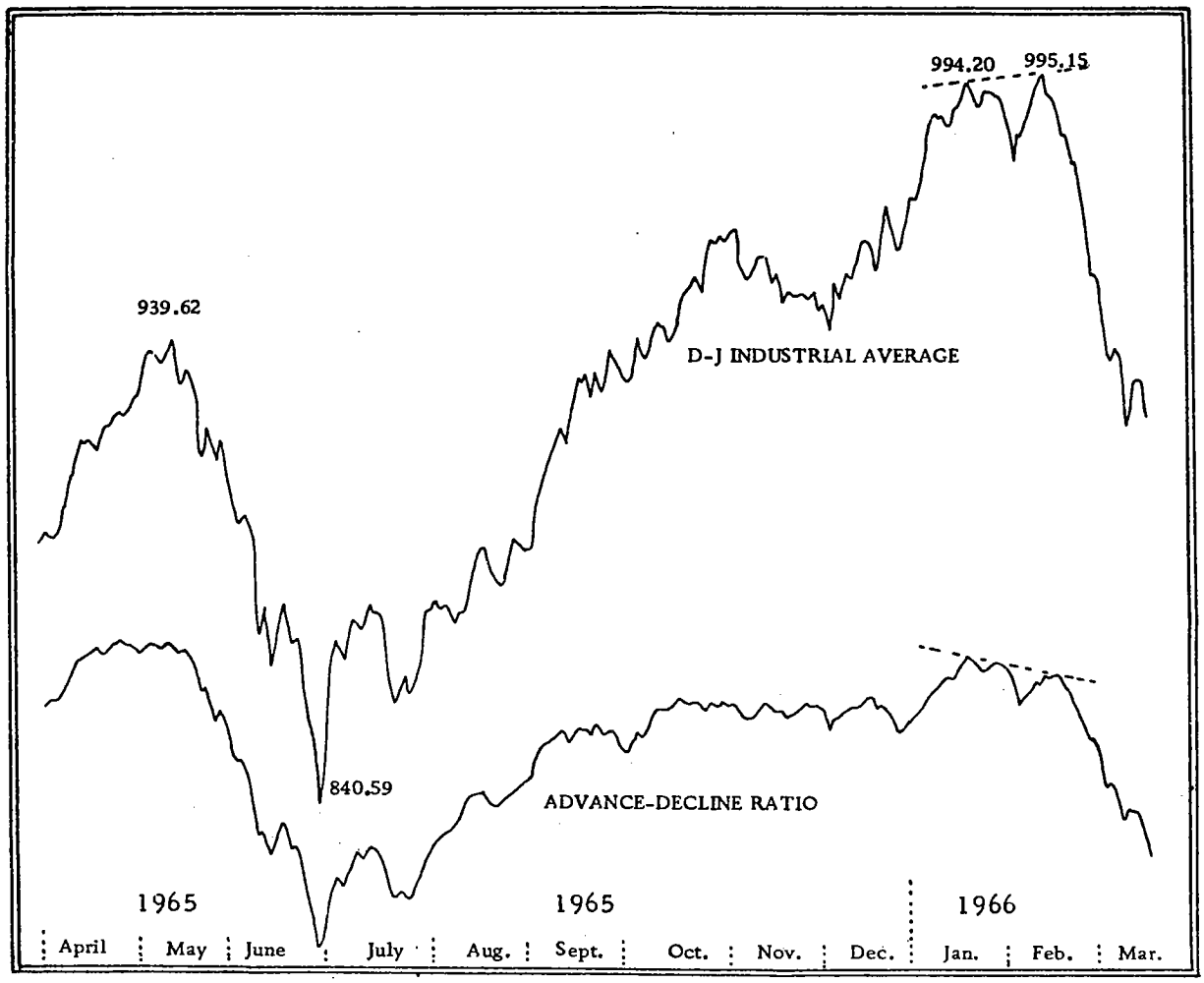
FROM LETTER 315: I have not discussed the advance-decline ratio in detail since Letter 310. But certain aspects of the current market suggest that this might be a good time to review the relationship of the A-D ratio and the Industrial Average.

This relationship is normally one of harmony, with both Industrials and the majority of stocks (as measured by the A-D ratio) moving up or down together. The rather rare periods of divergence, however, are the ones which point up the value of the "breadth-price" relationship in technical analysis.

One peculiarity of the current market is that the A-D ratio recorded its last high in May, 1965 (see chart, page 3). A violent correction occurred during May-June, 1965, and since that time Industrials have embarked on a broad advance to new record highs. The A-D ratio has followed more or less in direction, but it has never bettered its old 1965 high. In mid-January, 1966, the A-D ratio came within a fraction of the May, 1965 peak, but since that time the A-D ratio has retreated again.

It has now been nine months since the May, 1965 peak in the A-D ratio. Based on past case histories, we could be at or near a point where the price-breadth relationship assumes forecasting significance again. I believe it will be very important to observe whether the A-D ratio betters its old 1965 peak in the period ahead, or whether the A-D ratio refuses to penetrate that mark.

James Hughes of New York (who developed the A-D ratio along with Colonel Ayres of the Cleveland Trust Co.) noted that the following ...uence should be watched carefully: (1) The A-D ratio and the Industrial Average both establish highs. (2) The Industrial Average ...nen continues to record new highs but over a long period of time (Hughes uses four to nine months) the A-D ratio persistently refuses to record new highs of its own. Such extended periods in which the A-D ratio refuses to confirm new highs in Industrial, notes Hughes, are often the forerunners of major trouble.



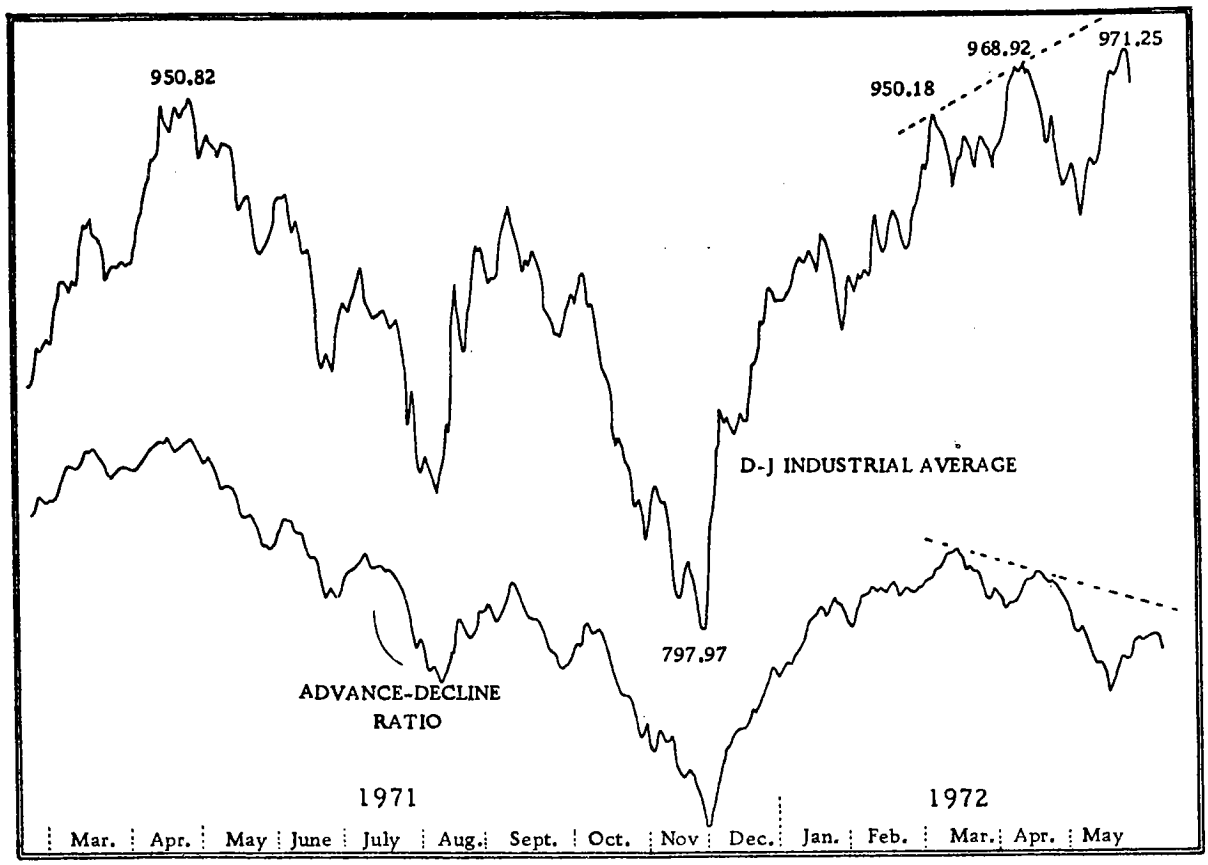
Periods of four to nine month lag in the A-D ratio occurred in 1919, 1929, 1947, 1957, 1959 and 1962. Each of these periods was followed by important declines or bear markets. However, the one great exception to this "rule" occurred during 1963-64 as many of my older subscribers well remember. The A-D ratio touched a peak in May, 1963, then moved sideways during the remainder of 1963 and most of 1964. On October 8, 1964, the A-D ratio finally bettered the May, 1963 peak. The belated and unprecedented confirmation occurred 17 months after the original 1963 peak.

In the current instance it has been nine months since the last A-D ratio peak. Enough time has elapsed so that I would judge that the breadth-price relationship is now unfavorable. However, with the 1963-64 exception so fresh in our minds, prudence dictates that we wait patiently for the actual outcome of the current lag in the A-D ratio. A forthcoming advance by the A-D ratio above its May, 1965 high would have the effect of reconfirming the bullish technical forces. Conversely, a continued refusal by the A-D ratio to better the 1965 high should be accepted as a "yellow light" for investors. (End of Letter 315 section).

In other words, two factors were of importance in the 1965-66 price breadth relationship, and both of these are clearly shown on the chart. (1) After the May, 1965, peak on both indicators, a sharp decline took place. Following the decline the Dow went on to new highs while the A-D ratio persistently refused to better its May, 1965, peak. By February, 1966, nine months had elapsed without a new A-D ratio peak, despite repeated new highs in the Dow. (2) During January and February, 1966, the Dow and the A-D ratio produced a major non-confirmation, with the Dow recording a new peak in February (995.15) and the A-D ratio unable to confirm (as shown by the diverging trendlines on the chart).

Now study the 1971-72 price-breadth chart (page4). Here the situation is essentially the same from the standpoint of (1) a long time lapse, ending in new recovery highs in the Dow (above the April, 1971, peak) but with the A-D ratio failing by a wide margin to better its own April, 1971, peak, and (2) non-confirmation between price and breadth during 1972.

I feel that it may be important to note that the Dow during 1971-72 was much weaker than it was during the comparable 1965-66 period. The proof is that the Dow during 1966 bettered its 1965 peak by a wide margin of 155 points (see charts). But the Dow during 1972 bettered its 1971 peak by only 20 points.



Another point of weakness is that the divergence during 1972 consumed far more time, formed a far bigger structure, and was marked by a series of three diverging peaks as against only two diverging peaks in 1966.

Conclusion: The market can do anything, and it is conceivable that the A-D ratio could now head up, better all its 1972 peaks and then better its April, 1971, peak. But this would be extraordinary action, action seldom, if ever, seen in this type of weakening situation. From the bearish standpoint (and I know almost no other advisory services have pointed this out — perhaps they are not aware of it) the price-breadth relationship of 1971-72 is as poor as I have ever seen it. The element of time (13 months without breadth bettering the April, 1971, high) and the "triple divergence" as shown by the diverging trendlines on the chart, make the whole structure ominously bearish. As far as the price-breadth relationship is concerned, the market is poised for a major descent from its 1972 levels (and indeed, as shown by the current level of the A-D ratio, this probably began in March when the A-D ratio topped out)!

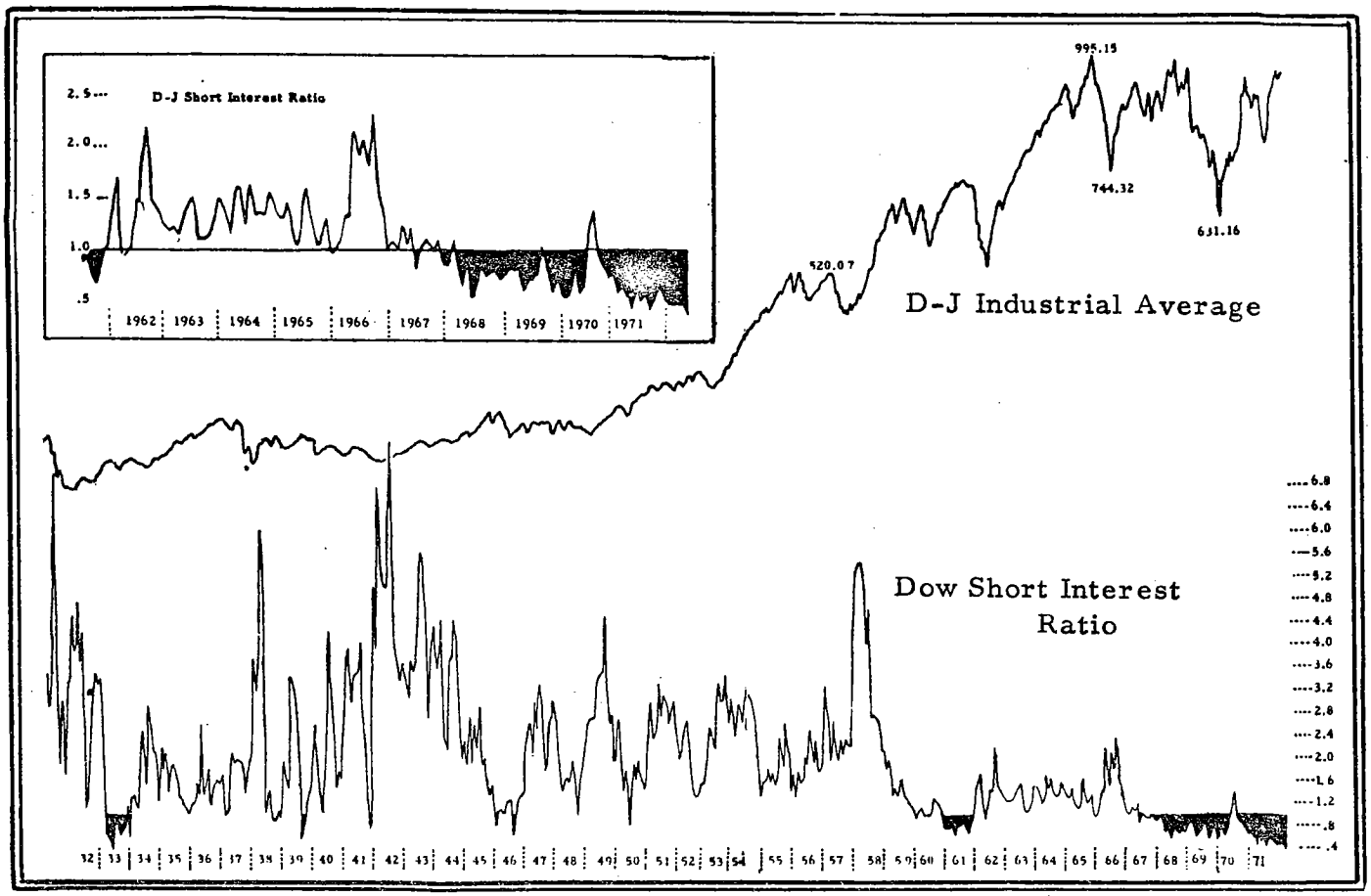
DOW SHORT INTEREST RATIO: The DSIR is a fascinating indicator developed by Bill Gordon of New York, and first introduced in the book, "The Stock Market Indicators" (1968). I have been in touch with Bill Gordon for many years, and he has provided me with the monthly tabulations of the DSIR.

Whereas the widely-followed short interest ratio is reported in Barron's (monthly) and is the ratio of the total NYSE short interest to average volume for the period, the DSIR is the ratio of the short interest in the 30 Dow Industrial stocks divided by average volume in those same stocks. Gordon has laboriously tabulated the full history of the DSIR going back to 1931, and I show that history on the page 5 chart.

In general, a reading above 1 is mildly bullish, a reading above 2 is quite bullish, anything over 3 is extremely bullish, and those rare readings over 4 have been wildly bullish. Conversely, anything under 1 is bearish and anything under .5 is extremely bearish. In the whole history of the DSIR there have only been eight readings under .5.

The large chart shows all readings under 1 as black areas, and it can be seen that there have been very few such areas since 1931. In other words, the DSIR does not give many bearish signals. The most recent history of the DSIR is quite interesting, and this is shown in more detail in the insert, which is simply an enlargement of the 1962 to 1972 period.

Note that the crushing market decline of 1969-70, the worst in a generation, did not come without adequate warning from the DSIR. All during 1968 the DSIR was in the black (under 1) area, and by 1969 the warning was clear enough. Following the



collapse, the DSIR pushed up to 1.40 in August, 1970, and the new upmove was underway.

Now the interesting thing was that during 1971 the DSIR again began plunging into the black area, staying there during the entire year. By 1972 the DSIR began registering its lowest consecutive series of readings in history, .44 in January, .45 in February, .43 in March, .44 in April. But the May reading was incredible. With the short interest in the 30 Dow Industrials dropping to 443 thousand, lowest in years, the DSIR sank to .36, its lowest figure in history.

This figure of .36 suggests that the bearish element, the group that speculates for the decline, has collapsed. It suggests that "literally everyone" thinks the Dow is headed through 1000 and higher, and no one wants to bet on a decline.

In the past, when that much optimism abounded and when the bears literally disappeared from the scene, the danger signals were flying. And that is what the DSIR is telling us today.

GOLD AND MONEY: As the forces of the printing presses and inflation run rampant in the US, the question which arises is "What is money?" The man in the street sees prices of everything going up in terms of the dollars he has in his pocket or his checking account and moans, "What am I holding? What is the true value of a piece of paper which is increasingly buying less here and increasingly wanted less throughout the world?"

To me, there are only two kinds of money. The first is what Barron's (May 22, page 22) calls "Store of Value" money such as gold coins. Here, the value is in the money itself. An American double-eagle gold coin will be accepted as money anywhere in the world, not because it is a type of US currency but because the intrinsic value is in the coin. The double-eagle contains an ounce of gold.

The second kind of money is paper money which is convertible into gold. In other words, it is money which is "as good as gold." This includes many leading currencies today. And at one time this definition included the dollar, which could actually be converted into gold by anyone. Later, the dollar was as good as gold for foreigners only, since US citizens were prohibited from converting their gold to dollars. And as of August 15, 1971, even this definition of the dollar was lost completely, since gold was embargoed by the US at that time.

So one way of looking at the gold price is to see it as an inverse barometer of faith in the US monetary position. The higher the gold price in terms of dollars, the lower the world's credulity in the US. It's worth wondering. And of course, this is the interpretation which strikes fear into the hearts of the Administration and into the hearts of every wild-spending politician. And well it should.

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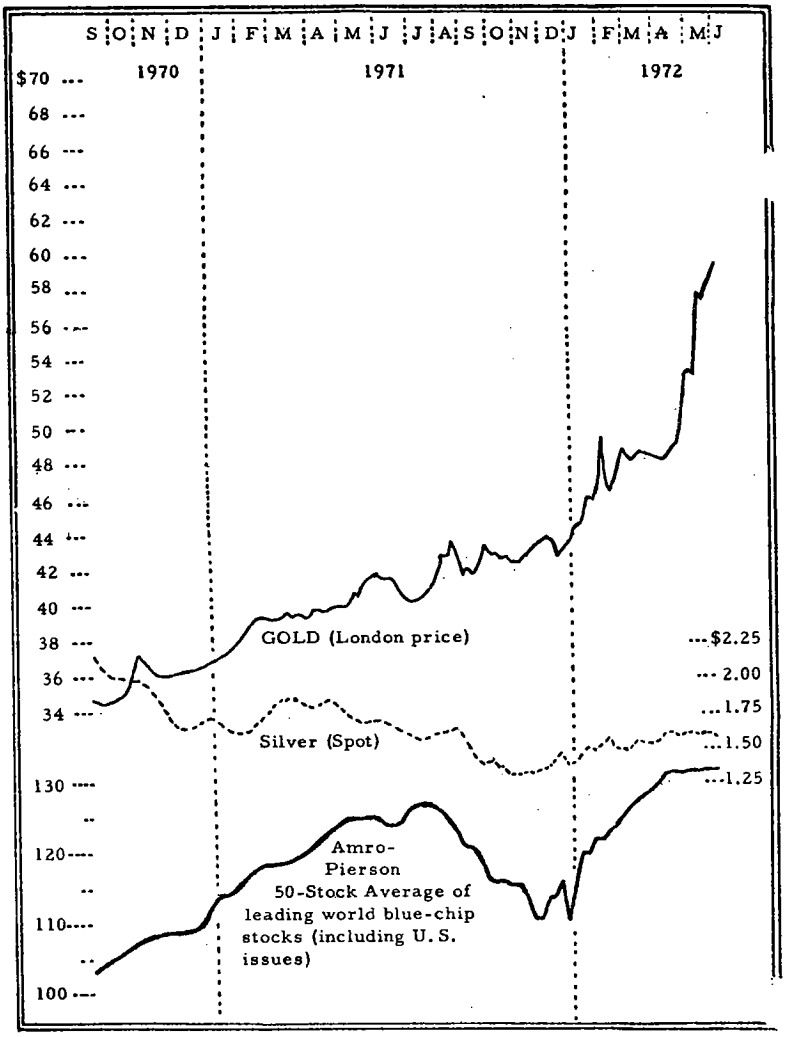
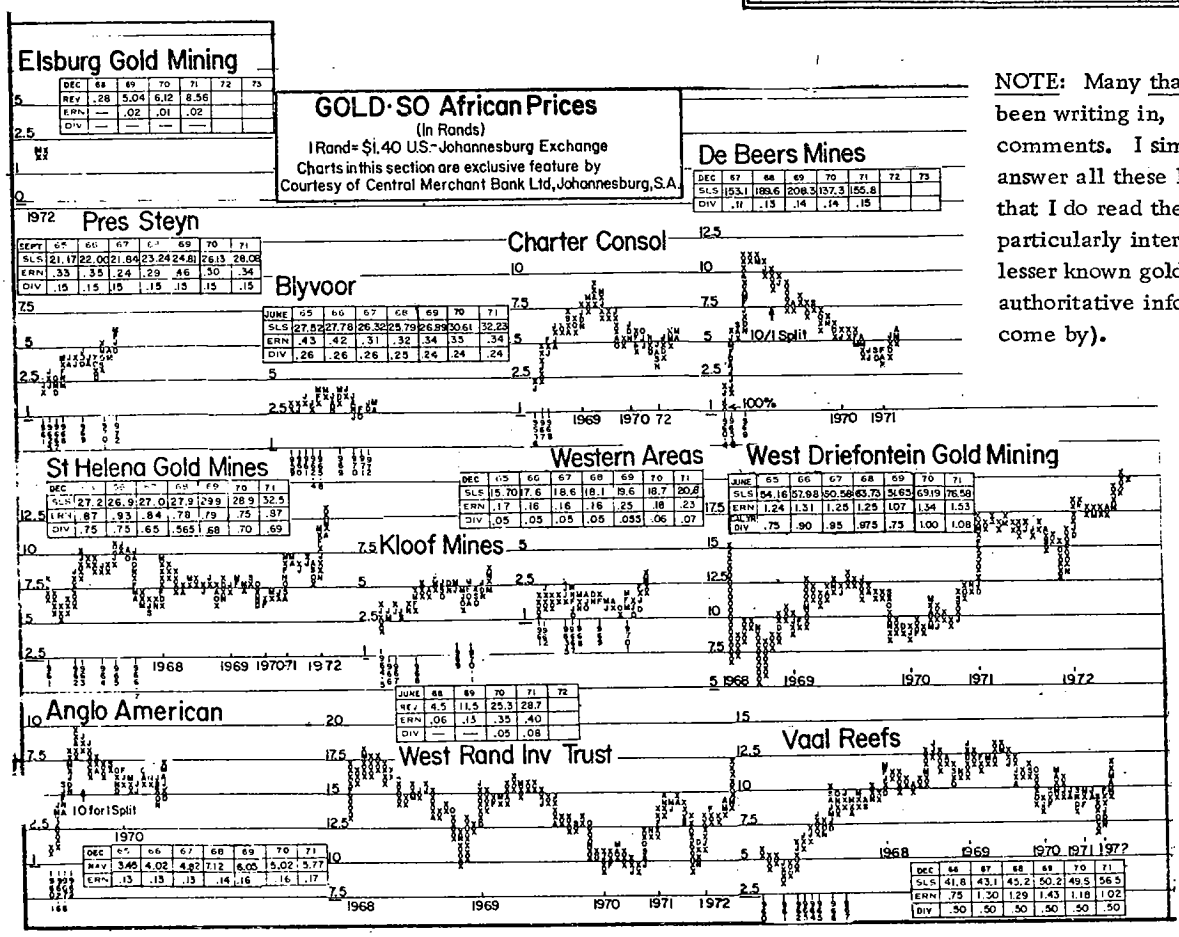
I am including the silver-gold metals price chart on this page, and here the chart speaks for itself. I have heard that a short position is building in gold bullion, and if true, this should act as a factor for strengthening the technical position of the already thin market in gold bullion. It should also serve as a buffer against severe downside corrections.

I am also including a number of point & figure charts of various S. African gold shares (from Jim Dines' Paflibe chart book, 18 E. 41st St., NYC 10017). My favorites for purchase on this list would be Vaal Reefs, West Driefontein, Kloof. It appears to me that during the next year or so we may be witnessing a general stampede into gold shares, to be climaxed by a final rush in on the part of the public. My barometer of public interest in gold shares, the volume in the four listed gold entities on the NYSE, is still not showing signs of any sustained volume (high volume would indicate real interest on the part of Wall Street and the public). So I tend to think that golds are still in the accumulation stage, which the public (which has been burned on the golds a number of times) remains skeptical.





NOTE: Many thanks to all of you who have been writing in, sending suggestions and comments. I simply do not have time to answer all these letters, but I want to state that I do read them all carefully. I am particularly interested now in articles on lesser known gold shares (about which authoritative information is very hard to come by).